**Taxing foreign rental income**

Mohammed Kamil Gohar

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Investment in foreign properties by a specific section of society in Pakistan has been a pretty common phenomenon, especially in countries like the UAE, UK and so on. Naturally, the earning of rental income from such properties situated abroad has given rise to the dilemma of whether this foreign source income would be taxable in Pakistan or not.

Income from property or rental income is taxable under Section 15 of the Income Tax Ordinance, 2001 (the Ordinance) at various slab rates depending upon the amount of such income. However, in the case of foreign rental income, many taxpayers have already paid the tax due on such income in the jurisdiction in which the property is situated and according to the taxation laws applicable there.

Regardless of the above payment of taxes, the Federal Board of Revenue (FBR) and more specifically the Automated Exchange of Information zones of the FBR have started issuing notices to those taxpayers who are earning foreign rental income from their properties situated in jurisdictions other than Pakistan “as to why not their foreign rental income be chargeable to tax in Pakistan”. This has given rise to a number of questions with regard to the taxability of foreign rental income in Pakistan, especially in light of the Treaties for Avoidance of Double Taxation.

Pakistan has entered into bilateral agreements for avoidance of double taxation with 66 countries under the Organization for Economic Coordination and Development (OECD) convention. Generally speaking, Article 06 of the Treaty for Avoidance of Double Taxation between Pakistan and various countries discusses the taxation of income from immovable property situated in a contracting state as: ‘Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.’

The above article links the taxation of income from immovable property with the jurisdiction in which such property is located rather than being taxed in both states – the state in which the property is situated and the state in which the taxpayer is a resident as it would defeat the purpose of the treaty for avoidance of double taxation.

However, the FBR is still pressing the issue standing their ground charging tax on foreign rental income in Pakistan. The argument put out by the FBR involves taxing the foreign rental income under Pakistan's tax laws and allowing a tax credit under Section 103 of the Income Tax Ordinance, 2001, of the amount of tax paid in the country in which the property is situated against such foreign rental income.

The root cause of this seemingly never-ending debate is the usage of the word “may” in Article 06 of the relevant treaties for avoidance of double taxation. Had the article used the word “shall”, then this debate wouldn’t have begun in the first place. However, it should be noted that the said article does not mention the taxability of said foreign rental income in Pakistan. Rather it only states that such income may be taxed in the jurisdiction in which the property is situated – thus, not explicitly providing the right for taxation of such foreign rental income to the taxation authorities in Pakistan.

The above analysis is supported by judgments of various appellate forums of neighboring countries of Pakistan wherein it was held that the phrase “may be taxed in that other state” denotes that amount so received by the assessee can only be taxed in contracting state where source of income has been generated rather than the contracting state where the assesses is a resident.

In addition to the above, it is worthwhile mentioning that the treaties for avoidance of double taxation are based on the convention of the OECD. Therefore, in order to interpret the wordings of the above referred treaty, the commentaries issued by the OECD have weightage.

The said commentary has been explained by paragraph 1 of Article 6 of the Treaty for Avoidance of Double Taxation as: ‘Paragraph 1 gives the right to tax income from immovable property to the State of source, that is, the State in which the property producing such income is situated. This is due to the fact that there is always a very close economic connection between the source of this income and the State of source.’

Since the Agreements for Avoidance of Double Taxation are entered into between countries under the OECD Convention, the clarification provided in the commentary of the OECD has weightage being the pioneers of these agreements.

In addition, the above view is also supported by the honourable Appellate Tribunal Inland Revenue, Lahore vide its judgment cited as ITA No 4299/LB/2022 wherein it was adjudicated that income from property earned in the UAE would only be taxable in the country in which it arises rather than in Pakistan.

The judgment was supported by taking the interpretation of the word “may” as determined by the honourable Supreme Court of Pakistan in its judgment cited as 2007 PLD 277. Moreover, it is also a settled matter that where there are two different interpretations of one matter, then the interpretation which favours the taxpayer should be considered. This principle has been laid down by the honourable Supreme Court of Pakistan vide its judgment cited as 2017 SCMR 140.

It should also not be forgotten that these treaties are agreements between two sovereign countries; therefore, interpretation agreed between Pakistan and the respective foreign country while entering into these agreements would be crucial in determining the outcome of this debate.

However, on the contrary, the honourable Appellate Tribunal Inland Revenue, Islamabad has given an opposing view to this vide its judgment cited as ITA No 1524/IB/2021 wherein it has been stated that the words “may be taxed” give simultaneous rights to both jurisdictions to tax foreign rental income.

Pakistan has had the misfortune of constantly changing taxation laws, something that has been a hurdle in letting taxation laws mature through the appellate process. Amendments are issued on almost a daily basis through SROs, notifications, circulars and the occasional bills/acts. Resultantly, the areas of law which are unclear never get settled.

Henceforth, although the matter of taxability of foreign rental income seems evidently in favour of the taxpayer as described in the self-speaking judgment of the honourable Appellate Tribunal, Lahore, the field formations of the FBR are more likely to defend ‘revenue’ until the matter is decided by the higher appellate forums and apex courts of Pakistan. Meanwhile, the existing taxpayers will be put through the same process of scrutiny, and tax may be charged on their foreign rental income in Pakistan, thus resulting in an increase in cost of doing business and unnecessary litigation cost on taxpayers.

In the midst of this legal debate, there is an easier resolution which could be sought by seeking further clarification from the OECD on a government level for the purpose of saving precious time and cost of the government’s machinery as well as creating more certainty amongst the business community with regards to taxation amongst taxpayers. Hopefully, the government will take the necessary measures needed to settle this dilemma.

The writer is an associate member of the Institute of Chartered Accountants of Pakistan. He has also served as the vice chairman of the Federal Taxation Sub-Committee of the Karachi Chamber of Commerce and Industry.